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TAGS: [ETRD](#) [EIND](#) [KIPR](#) [ECON](#) [CH](#)
SUBJECT: CHINA/IPR: APPLE TAKES A BITE OUT OF
CHINESE FAKES

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for Internet distribution.

Summary

¶1. (SBU) As amazing as it seems, computer maker Apple Inc. had no global security team - including inside China - until March 2008, when they hired away the team from Pfizer that formed and led a multi-year crackdown on counterfeit Viagra production in Asia. Now with Apple, Don Shruhan, based in Hong Kong, has taken the first basic step of registering the company's trademarks in China and Hong Kong and is targeting retailers, manufacturers, distributors, and online vendors to take a bite out of China's counterfeit iPod and iPhone production. Early evidence suggests nearly 100 percent of Apple products in unauthorized mainland markets are knock-offs, while factories in Guangdong province are exporting enough counterfeits to single-handedly supply the world with fake Apple products. End Summary.

From Viagra to iPods

¶2. (SBU) Apple Inc., the Cupertino, California-based designer of Mac desktop and laptop computers, was not especially well known in mainland China before

the introduction in 2001 of its now-ubiquitous iPod music player and, more recently, the iPhone. Now those products are so popular worldwide that China's notorious counterfeit markets are filled with knock-off versions. After finally recognizing the threat, Apple hired Don Shruhan from Pfizer in March as Senior Director of Security for Asia Pacific to design and launch the company's security strategy, including anti-counterfeiting efforts, in the region. His focus is on China, where he is "afraid" of the volume of fake Apple products being produced, though he is so far unable to quantify the scope. Shruhan's boss at Pfizer, John Theriault, was also hired by Apple, and is now VP of Global Security, based in California.

13. (SBU) Shruhan, who over the past five years developed and implemented a security and anti-counterfeiting strategy for Pfizer aimed largely at tackling fake Viagra production in China, said that he is starting more or less from scratch at Apple - the company had not so much as registered its trademarks in China or Hong Kong until he joined the company early this year.

China: Source of Fake (and Real) Apples

14. (SBU) Effectively all of Apple's iPod and iPhone production is performed by sole-sourced third party vendors in China, largely in Guangdong province --

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China's manufacturing heartland and counterfeit capital. (Note: MacBook laptop computers are also produced in China, but are less popular than the company's other products and not subject to counterfeiting. Shruhan has not yet spotted any fake Apple computers. End Note.) Media reports indicate that a single plant operated by electronics subcontractor Foxconn employs 200,000 workers making iPods in Longhua, Guangdong province. While cities in that province, which also include Shenzhen and Guangzhou, are far and away the biggest source for fake Apple products, Shruhan says that internal controls at subcontracted facilities, combined with independent audits, are good enough that he does not believe authorized plants are producing unlicensed products in a so-called "third shift" scenario. He explained that Apple's system for tracking each product's unique serial number appears very effective, and more sophisticated than Pfizer's. Instead, he attributes the usually poor-quality fakes to independent operators without links to the licensees, though he acknowledges the manufacturing molds for iPods or iPhones could be removed from licensed factories and used in illegal production. This can result in fakes that appear flawless on the surface, but whose internal hardware is substandard. Shruhan has discovered, for instance, what appear to be real iPods with 80GB of storage, but that in fact have only a very inexpensive 1GB hard drive inside.

Exports Shipped through Hong Kong

15. (SBU) Whatever means counterfeiters are able to exploit, the numbers are compelling: Shruhan notes that customs seizure data definitively show that there is enough counterfeit production of Apple products in Guangdong to effectively make China the single source for the world's fake iPods and iPhones, many of which are transshipped via Hong Kong to points onward. Even with the introduction of genuine iPod and iPhone retail sales in China (through authorized dealers and, more recently, an

actual Apple Store), Apple's marketing strategy here is still in its infancy. The popularity of its products is stronger outside of China. In three recent raids in India, all fake Apple products were found to have been transshipped through Hong Kong (from China). Also, goods bound by air for Mauritius were recently seized in Hong Kong. Shruhan explained that Hong Kong's port has historically received less scrutiny than others for outgoing goods. In his experience with Pfizer, he found Hong Kong customs authorities reluctant to launch investigations that they fear could slow port traffic - especially in comparison to more willing mainland customs officials - but could be convinced to cooperate if negative publicity can be minimized.

¶6. (SBU) Hong Kong is not only the exit port for outbound fakes, Shruhan said, but is also the point

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of entry for legitimate Apple products entering China's gray market. By buying iPods and iPhones in Hong Kong, outside of mainland China's customs zone, entrepreneurs willing to transport products across the border can resell them at an instant profit of approximately 25 percent to mainland Chinese accustomed to paying import duties and value-added taxes.

Retail Outlets

¶7. (SBU) Genuine Apple products in China until recently were sold only through authorized resellers. In July, the company opened its first official Apple Store in Beijing and plans to open another - the world's largest - in the Chinese capital in early 2009. Outside of these legitimate channels, vendors misrepresenting themselves as "authorized" may sell the occasional real iPod or iPhone, but predominantly offer fakes. Shruhan recently completed an informal (and statistically insignificant) survey of markets in Beijing, including the notorious Silk Street Market, where his team found that, while many Apple products "look good," nearly 100 percent were fake.

The Approach to Fighting Fakes

¶8. (SBU) In many ways, Shruhan intends to model Apple's security plan in China on his successful experience at Pfizer, so he can quickly unroll a strategy. In broad terms, the company will target retailers first to raise their costs and get counterfeit products off the street. Next, Shruhan will work with the authorities to crack down on major manufacturers and distributors of fakes to undermine the supply of fake products. Finally, he will seek out vendors who sell knock-offs online. To accomplish this will require not only a team of investigators, which Shruhan has subcontracted, but also tools like a laboratory to begin accurately tracing the source of counterfeit goods. A lab that can perform forensic analysis on individual parts like batteries, for example, can help to locate high-volume manufacturers of such component parts.

Cooperation with the Chinese Government

¶9. (SBU) A key component in Shruhan's plan is close cooperation with the Public Security Bureau (PSB). Pfizer enjoyed very strong support from the PSB in pursuing counterfeit pharmaceuticals, in large part due to health and safety implications at a time when

China was particularly sensitive to such image issues after the use of lead-based paint in toys and unsafe Heparin. Shruhan is unsure how much the PSB will focus on Apple's issues, but believes a safety angle like shoddy devices causing fire hazards will

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strengthen his case. Short of this, his most persuasive argument will be the economic impact of counterfeiting: lost tax revenue and jobs. Apple is studying what this costs the Chinese Government per counterfeit device sold. Whatever degree of support the PSB offers, Shruhan accepts that, as with Pfizer, the reality of successful cooperation will be that his team "does 95 percent of the investigative work," turns case files over to the PSB, and "gives the PSB 100 percent of the credit" for successful enforcement actions. The payoff is worth it. China has some of the strictest penalties around for counterfeiters, he claimed - if the PSB can successfully prosecute a case. Shruhan recalled a pharmaceuticals case in which the counterfeiter was sentenced to ten years and received a USD 250,000 fine.

¶10. (SBU) Apple's first raids will be carried out in Shenzhen in Guangdong province, where Shruhan has identified at least one major underground factory. In such a raid, carried out by the PSB, the factory will be shut down by authorities only if its output exceeds the criminal threshold that under Chinese law represents production on a commercial scale: RMB 150,000 (USD 22,000). In addition to working with the PSB to shut down manufacturers, Shruhan is also encouraging China's local Administrations of Industry and Commerce (AICs) to raid retailers. Such raids may not put vendors out of business, but associated fines and penalties from civil suits will raise their costs. Shruhan said that low profile retail raids are a good option for Apple, a company that wants to stay away from too much publicity surrounding this issue. The evidence Apple gathers doing market surveys, including the names of infringing shops, the number of fakes found, and the trademarks being violated, will be provided to the AIC for support in upcoming raids in cities including Shanghai, Beijing, Guangzhou, and Shenzhen.

¶11. (SBU) Shruhan describes his relationship with China Customs, developed over five years of joint efforts to fight fake drugs, as very cooperative, and he is already getting the support he needs, including five export seizures in August. A key element of his relationship with customs officials in the past has been providing them with the training they need to identify counterfeit goods in the field. In addition to building strong relationships with investigators and law enforcement agencies, Shruhan knows that currying favor with the Supreme People's Procuratorate and the courts are essential in ensuring effective prosecution and sentencing.

Selling the Plan in California

¶12. (SBU) While Shruhan has the benefit of his

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Pfizer experience in China, he laments that Apple lawyers do not. Based in California, the company's inexperience has slowed cooperative progress with Chinese Authorities. Officials at Lowu Commercial

City, one of China's notorious counterfeit markets near Hong Kong, asked Apple for training and evidence of counterfeit sales in their shops. However, reluctance by the company to accept standard Chinese legal documents and other problems in corporate communication have so far prevented such cooperation. Shruhan has an ally at Apple's Cupertino headquarters who will help him win the support he needs to build an effective security operation in China. John Theriault, former Vice President of Global Security for Pfizer, was Shruhan's boss for the last five years, and is the one responsible for bringing Shruhan to Apple, where Theriault is now Vice President of Global Security. Theriault, said Shruhan, has already pitched the China security strategy to Steve Jobs.

Comment

¶13. (SBU) Shruhan and Theriault spent five years building an effective security plan for Pfizer, resulting in high-profile raids and seizures of large quantities of counterfeit drugs like Viagra. This was due in large part to the high priority the Chinese Government placed on health and safety issues. Now at Apple, they have an excellent understanding of China's underground manufacturers and global distribution channels that will serve them well as they seek to stem fake iPod and iPhone production. However, the key will be whether their personal relationships with customs, law enforcement, and judiciary officials will be enough to focus the Chinese Government on Apple's non-health-related problems as they seek to make life uncomfortable for counterfeiters. End Comment.